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IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

Sac. No. 6153

JOHN DEERE PLOW COMPANY OF MOLINE (AN ILLINOIS CORPORATION),

Plaintiff,

vs.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Defendant

STATEMENT AS TO JURISDICTION

In compliance with Rule 12 of the Rules of the Supreme Court of the United States, as amended, plaintiff-appellant submits herewith its statement particularly disclosing the basis on which the Supreme Court has jurisdiction on appeal to review the judgment of the Supreme Court of California entered in this cause.

Opinion Below

The opinion of the Supreme Court of California is reported in 38 Advance California Reports, Second Series 216, 238 Pacific 2d 569. A copy is attached hereto as Appendix A.

Jurisdiction

The judgment of the California Supreme Court was entered on December 19, 1951. A petition for appeal was pre-

sented to the Chief Justice of the Supreme Court of California on February 25, 1952, and disallowed by him the same day. The petition for appeal was presented to Associate Justice William O. Douglas of the United States Supreme Court on February 28, 1952, and was allowed by him on that day.

The jurisdiction of the Supreme Court to review this decision by appeal is conferred by Title 28, United States Code, Sections 1257 and 2101(c). The following decisions sustain the jurisdiction of the Supreme Court to review the judgment in this case on appeal: *Market Street Railway Co.* v. *Commission*, 324 U. S. 548; *Butler Brothers* v. *McColgan*, 314 U. S. 649, 315 U. S. 501; *United States* v. *Burnison*, 338 U. S. 822, 329 U. S. 87; *Canton R. Co.* v. *Rogan*, 340 U. S. 814, 511; *Hamilton* v. *University of California*, 293 U. S. 245.

The federal question was raised in both the Superior Court and the Supreme Court of California. Paragraph XIV of the complaint raised the constitutional question in the following words:

> "• • • and the tax so imposed took the property of the plaintiff without due process of law, and denied to the plaintiff the equal protection of the laws, in violation of rights guaranteed to the plaintiff by the Constitution of the United States of America and the Constitution of the State of California."

The brief of plaintiff in the Superior Court contained forty pages of argument devoted to supporting the constitutional proposition, which was phrased as follows (Brief, p. 97):

> "Such assessment of tax and the subsequent collection thereof constituted a taking of the plaintiff's property without due process of law and denied to the plaintiff the equal protection of the laws, in violation of the Fourteenth Amendment to the Constitution of the

United States and the Constitution of the State of California."

This contention was decided adversely to plaintiff, a judgment being entered for defendant. Thereafter, within the time permitted by law, a notice of appeal to the California Supreme Court was filed in which the constitutional question was stated as the principal ground of appeal in language identical to that quoted immediately above.

Plaintiff's opening brief in the California Supreme Court, in the statement of the "Question Involved," stated the issues as follows:

> "The question presented for decision on this appeal has a twofold aspect. First, was the assessment of additional franchise tax against appellant for the taxable year involved made by a method not authorized by the statutes of the State of California for the reason that it operated to attribute to appellant, as income arising out of its property and operations in California, an amount of income substantially in excess of and having no reasonable relation to the income in fact derived from such property and operations, so that said assessment of tax and the subsequent collection thereof constituted invalid acts? Second, for the same reason, did the subsequent collection of said tax, if its assessment is held to be valid under the California statutes, constitute a taking of appellant's property without due process of law and in denial to appellant of equal protection of the laws in violation of the Fourteenth Amendment to the Constitution of the United States and in violation of the Constitution of the State of California?"

It will be seen that the first issue was one of statutory interpretation, and the second issue was that if construed contrary to plaintiff's position, the statute was violative of the due process and equal protection clauses of the Fourteenth Amendment.

The California Supreme Court stated plaintiff's constitutional challenge, and rejected it, in the following words (Appendix A, p. 21):

> "Plaintiff maintains that such formula attributes to California income derived wholly from business done without this state, so that such allocation is not only contrary to the governing act but likewise is objectionable as violative of the due process and equal protection of the law clauses of the Fourteenth Amendment. But an examination of the record in the light of settled legal principles sustains the use of the challenged formula as a reasonable method of apportionment for determining plaintiff's franchise tax liability in this state, and accordingly the judgment must be affirmed."

Question Presented

Whether the due process and equal protection clauses of the Fourteenth Amendment permit a state to allocate net income to itself for tax purposes by an averaging formula in a case where the evidence shows that local conditions render it impossible for the local business to be as profitable as the business conducted in other states, and where the disparity of both local conditions and local profits from the average is substantial.

Statute Involved

Section 10 of the California Bank and Corporation Franchise Tax Act (Cal. Stats. 1929, Chapter 13, as amended) is set forth in Appendix B.

Statement of the Case

Plaintiff and appellant (hereinafter referred to as "appellant") is an Illinois corporation qualified to do and doing business in California. Its business consisted of the sale to dealers of a full line of agricultural machinery,

implements and tractors. It owned and operated five jobbing houses, of which one was located in California, at San Francisco. It was one of some 84 corporations wholly owned by Deere & Company, another Illinois corporation, and most of the products handled by appellant were manufactured by Deere & Company and other subsidiaries of Deere & Company. In the taxable year involved, no manufacturing was done in California by appellant or any other member of what has been held herein to be the Deere unitary group.

In 1934 Deere & Company entered in a distribution arrangement with Caterpillar Tractor Company to meet the competition offered by International Harvester Company and Allis-Chalmers Manufacturing Company, both of whom manufactured a line of farm equipment competitive with the Deere line and both of whom had commenced manufacturing track-type tractors. The Deere group did not manufacture this type of tractor and did not wish to. Caterpillar, which did do so, did not manufacture a line of farm equipment. To enable their dealers to meet competition by being able to offer both a complete line of agricultural implement equipment and a full line of wheel and track-type tractors to pull them, Deere & Company and Caterpillar Tractor Company made an arrangement whereby the dealers of each could become dealers of both. Deere & Company also entered into this arrangement in order to develop the sale of its industrial tractors.

This competitive situation was particularly acute on the West Coast, because soil and other conditions peculiar to that section caused track-type tractors to be more widely used in farming than wheel tractors, whereas elsewhere wheel tractors were the prevailing type in farm use. In California, unlike other states, appellant established common dealers by discontinuing doing business

with practically all its former dealers, numbering about 250, and by marketing its goods through Caterpillar dealers in areas formerly served by the discontinued dealers. It retained 25 of its old dealers and replaced the balance with 19 Caterpillar dealers.

This changeover caused appellant's California jobbing house extra expense. An extensive program to educate and train the new dealers and their service departments was undertaken by the California house. Its repair facilities and staff had to be enlarged. It had to accept the return of the stocks in the hands of the discontinued dealers, which resulted in unusual handling and sorting expenses, in addition to reconditioning costs. Extra warehouse and transfer costs also resulted.

The prices which appellant was charged by Deere & Company for goods purchased from it were fixed by Deere & Company by applying specified discounts to the minimum resale price to the dealers. All jobbing houses were charged the same price appellant was charged, with adjustments for freight differentials. These were fair prices: as the trial court expressed it in the findings:

> "The prices and terms at which the plaintiff purchased goods for its San Francisco house from Deere & Company allowed it a gross profit margin comparable to that allowed independent jobbers by certain manufacturers of products competitive with the Deere line."

This method of pricing allowed appellant's San Francisco house a gross profit margin comparable to that of the other jobbing houses in the Deere group.

Although appellant's California gross profit margin was substantially the same as that of the jobbing houses in other states, the same was not true of the ratio of expenses and assets to gross sales. Due to the conditions peculiar to

California stated above, the expenses of earning gross profits in California were substantially higher than the average which prevailed throughout the Deere group. As the California Supreme Court expressly recognized, this disparity was not caused by any charges made by the parent corporation, for there were no unfair or peculiar charges made by the parent corporation to any of the jobbing houses. The disproportionately high cost of sales in California, in comparison with the group's national average, was found as a fact by the trial court and was stated in terms of each of the three factors used in the California allocation formula, as follows:

1. In the property factor, it required $18.26 of property in California to produce each $100.00 of sales, whereas as a national average for this taxpayer only $6.76 of property was required to produce the same volume of sales;

2. In the payroll factor, it required $6.76 of wages and salaries to produce $100.00 of sales in California, whereas the national average per $100.00 of sales was $4.46;

3. In the sales factor, again in terms of $100.00 of sales, the California selling expense was $13.676 and the national average was $8.781.

The trial court did not find that the California gross profit margin was substantially the same as the national group average, but there was evidence to that effect which led the California Supreme Court to make the following finding (Appendix A, p. 25):

> "The prices and terms so fixed for plaintiff's San Francisco house allowed it a gross profit margin from its sales comparable to that realized by the other jobbing houses operating in the Deere organization."

In addition, both courts recognized and stated that because of the Caterpillar arrangement appellant gave more cash and volume discounts in California than on the na-

tional average, and its interest income from financing dealers was less.

Appellant filed its franchise tax return for the taxable year ended October 31, 1938, reporting its net income for the income year ended October 31, 1937, as required by California law. This return showed a California net income of $70,446.79, which figure was also shown by its books and records. The Franchise Tax Commissioner (subsequently replaced by the Franchise Tax Board) assessed an additional tax based on the consolidation of the net income of the entire 84 corporations in the Deere group and the allocation to California, by means of the three-factor formula of property, payroll and sales, of a net income of $378,047.71. The additional tax of $12,167.53 was paid, a refund claim was filed and denied, and suit to recover the additional tax was filed in the Superior Court in and for Sacramento County on June 17, 1942. The case came on for trial on October 14, 1947, and was tried for ten court days. Judgment for the defendant Franchise Tax Board was entered on February 17, 1950.

The evidence at the trial not only established the facts which have been summarized before, but also included a schedule reconciling defendant's allocation of net income with that used in appellant's return, showing the effect of the disproportionately high California expenses and other figures used in the formula. Appellant claimed that this schedule demonstrated that if the formula was corrected to remove the California abnormalities, the corrected result would be the same as that reported in appellant's return. This schedule and accompanying explanation were admitted into evidence, but were neither accepted nor rejected in the findings of fact.

Following entry of judgment for defendant, plaintiff-appellant appealed on April 14, 1950, within the time allowed by law, to the California Supreme Court. All objec-

tion to the consolidation of net income was abandoned, and the appeal was confined to statutory and constitutional objections to the use of the formula on this record. On December 19, 1951, that court entered a decision affirming the judgment below, and rejecting appellant's contention that on this record the statutory formula reached a result prohibited by the due process and equal protection clauses of the Fourteenth Amendment.

The Federal Questions Presented Are Substantial

The federal questions presented are substantial for two principal reasons: *first*, because under prior decisions of the Supreme Court appellant should have prevailed on the facts established and found by the state courts; *second*, the California courts have in this case enunciated a rule of national implication to the effect that the particular three-factor formula which California, in common with many other states, employs can never be attacked on constitutional grounds in the case of a so-called unitary business.

1. Heretofore the Supreme Court has repeatedly recognized that an allocation formula is based on an assumption of relative uniformity of conditions throughout the business which is being taxed. This assumption has particular force where the business in question is of the same general character in all the geographical divisions in which it operates. Accordingly such businesses have been described as "unitary," a word plainly derived from the term "unit rule," a descriptive term formerly applied to allocation formulae. See *Sanford* v. *Poe* (*Adams Express Co.* v. *Ohio State Auditor*), 165 U. S. 194, and *Butler Brothers* v. *McColgan*, 315 U. S. 501.

A corollary of the unit rule is that if in a particular case the evidence overthrows the assumption of relative uniformity, an allocation formula cannot properly be used, at

least unless it properly takes into account and compensates for the absence of uniformity of conditions. State tax administrators have historically bitterly opposed the restrictions implicit in this corollary, and historically their opposition has met with some success in the state courts and no success in the federal courts. There are three leading expositions of this limitation in Supreme Court cases.

The first of these is *Wallace* v. *Hines*, 253 U. S. 66, where Mr. Justice Holmes spoke for a unanimous court. That case involved a North Dakota franchise tax measured by an allocated portion of the total value of the taxpayer's outstanding stocks and bonds. The formula for allocation was, in the case of railroads, track mileage. The statutory formula was held to violate the due process clause in the particular case because the particular railroad taxpayer had expensive terminals and other properties in other states which were not duplicated in North Dakota. The effect of a track mileage formula was to draw some of the value of those out of state properties into North Dakota to be taxed there. Mr. Justice Holmes epitomized the vital objection to the use of the formula in that case in these words:

> "It naturally follows that the great and very valuable terminals of the roads are in other States. So looking only to the physical track the injustice of assuming the value to be evenly distributed according to main track mileage is plain."

The second case is *Hans Rees' Sons* v. *North Carolina*, 283 U. S. 123, where Mr. Chief Justice Hughes spoke for a unanimous court which still included Mr. Justice Holmes, the author of the opinion in *Wallace* v. *Hines, supra*, among its members. This case involved the North Carolina net income tax, which used an allocation formula identical to the one which had been sustained by the Supreme Court in an

earlier case (*Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113). The North Carolina Supreme Court held that since the business was unitary and the formula a generally valid one, evidence to show that in a particular case it operated to allocate out of state income to North Carolina was irrelevant. (199 N. C. 42, 153 S. E. 850.) The Supreme Court reversed and held that the use of the formula in the particular case violated the due process clause, because the evidence, based on separate accounting, showed that the actual North Carolina income was substantially less than that the formula allocated to the state. An analysis of the formula discloses that it was a one factor formula taking into account only tangible property owned by the taxpayer in the state in relation to that owned by it everywhere. This taxpayer owned substantial idle property in North Carolina, and it leased and did not own its New York plant. This lack of uniformity in the conditions in the several states produced the distorted and unconstitutional results which the taxpayer's evidence established did exist.

The third case is *Norfolk & Western Ry. Co.* v. *North Carolina*, 297 U. S. 682, where Mr. Justice Cardozo, also for a unanimous court, discussed the governing principles supporting the use of formulae and the type of showing a taxpayer must make to overthrow a formula. The particular taxpayer failed to make the required showing. The following statement in the opinion prefaced the court's discussion of the facts (297 U. S. at 685):

> "A segment of the line may operate under handicaps resulting from the nature of the traffic, the topography of the country, the maladjustment or inadequacy of passenger or freight tariffs in one district or another. As applied to such a segment the average mileage prorate of the entire railway system may be an arbitrary test * * *."

Thereafter the court analyzed the taxpayer's showing in language which illuminates the requirements so vividly that the entire paragraph is quoted, from 297 U. S. at p. 688:

> "We are unable to accept the argument for the appellant that its burden was discharged when it gave evidence of the ratio between actual and average expenses while keeping silent as to the ratio between actual and average receipts. The statutory formula is not framed on an assumption that gross operating revenues are uniform actually for every mile throughout the system. It is not framed on an assumption that for every mile of the system there is uniformity of expense. Such assumptions, if made, would be contrary to notorious facts. What the formula does assume is this, that barring exceptional conditions there will be throughout the system such an average relation between revenues and expenses as will cause the net income of a part to vary, in proportion to the mileage, with the net income of the whole. The implications of the formula being what they are, a taxpayer does not escape the application of the statute by evidence directed to only one of the related terms. Its evidence to be effective must be directed to each of them alike, for only thus can the assumed relation between them be proved to be unreal. This taxpayer disclaims the duty and even the endeavor to respond to such a test. It varies the numerator of the fraction while accepting the denominator."

The California Supreme Court did not suggest that appellant had failed to establish its case under the tests found in those cases. It did not deny, and it could not have done so truthfully, that the evidence, and indeed the findings of the trial court, established that the expenses of turning products into dollars in California substantially exceeded the national and out of state average. Nor did it seek to take refuge in the failure of the trial court to find that the California margin of gross profit was substantially the same as in the out of state business, but instead it supplied the

omission in its opinion, a finding based on evidence introduced by appellant at the trial. Accordingly the missing element in the taxpayer's case in the *Norfolk & Western* case is present in this case, and the California court does not deny the fact.

Apparently the California Supreme Court does not feel bound by these decisions because of the later decision in *Butler Brothers* v. *McColgan*, 315 U. S. 501, affirming 17 Cal. 2d 664, 111 P. 2d 334. That decision, together with some more recent decisions of the California Supreme Court, is cited throughout the opinion, as is *North American Cement Corporation* v. *Graves*, 299 U. S. 517. Responsive to the argument made below in reliance on the three cases just discussed, the California Supreme Court said (238 P. 2d at 574):

> "In the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income (Butler Brothers v. McColgan, supra . . .) • • • but its propriety in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process. (North American Cement Corp v. Graves, supra, 299 U. S. 517; Ford Motor Co. v. Beauchamp, 308 U. S. 331, 336.)"

By this statement the California court squarely joins issue with the three cases from the Supreme Court discussed above. Clearly, unless one of the decisions the California court cites has overruled the three older cases, this case presents a constitutional question of real importance.

None of the cited cases supports the use the California court makes of them. There was no evidence of disparity of conditions in the *Butler Brothers* case, and not only did the Supreme Court refer to that fact ("The fact of the matter is that appellant has not shown the precise sources of its net income of $1,149,677. If factors which are responsible for that net income are present in other States but not present in California, they have not been revealed." 315 U. S. at 509.), but the California court itself did so and distinguished the *Hans Rees* and *Norfolk & Western* cases on that ground. See *Butler Brothers* v. *McColgan*, 111 P. 2d at 341. Also, the State in its brief in that case in the Supreme Court, did not ask that those cases be overruled but instead distinguished them on the same ground. Brief of Appellee, No. 283, October Term, 1941, pp. 39-40. Thus the *Butler Brothers* case did not overrule the three cases on which we rely.

North American Cement Corp. v. *Graves*, 299 U. S. 517, cited by the California court, is a favorite of that court, which has frequently cited it. We have, however, not found instances in which the Supreme Court has deemed it authoritative. The case was decided by a memorandum decision, and strangely enough that was also true in both the New York courts from which it came. It is difficult to believe that the Supreme Court intended that it overrule three unanimous decisions from the same court.

Ford Motor Co. v. *Beauchamp*, 308 U. S. 331, refers to none of the cases under discussion, not surprisingly since none of the evidence in the case tended to establish a disparity between conditions in the taxing state and those prevailing in other states in which the taxpayer did business.

The most recent expression from the Supreme Court in a relevant field is in *Treichler* v. *State of Wisconsin*, 338 U. S. 251, decided in 1949. This was an inheritance tax case, and it refused to permit convenience to justify measuring

an excise tax by property located in another state. Instead of weakening theretofore established doctrine, that case reaffirms it. It may be significant to note that the franchise tax here involved is, like an inheritance tax, an excise tax in which property values or income constitute the measure of tax, not the subject of it. Accordingly, that case would refute any suggestion, although no such suggestion was made by the California courts, that the power to reach extra-state values is greater in the case of an excise tax than in the case, for example, of a direct net income tax.

It is evident, we submit, that if the decision of the California courts is allowed to stand, what has heretofore been considered a well settled rule of decision of the Supreme Court will no longer retain vitality, at least not in California. Except for the decision of the California courts in the instant case, there would be no reason to doubt the continuing vitality of that rule of decision. Since the area of doubt will extend to all forms of state taxation, this raises a substantial and important federal question.

2. The opinion below recognizes no limitations on the constitutional power of California to use the three factor formula in the allocation of the net income of an unitary business. Apparently it perceives something about the three factor formula which distinguishes it from the simpler formulae which have been held subject to successful attack.

Fifteen states, including California, are now using the three factor formula of property, payroll and sales. Five others use a three factor formula of property, manufacturing costs and sales. See Silverstein, *Apportionment in Taxation of Multistate Business*, 4 Tax L. Rev. 207, 258, where the various formulae in current use are collected. The decision of the California Supreme Court therefore has application to nineteen states in addition to California. The importance of the decision and of the federal question it involves is thus readily apparent.

That we have correctly stated the intended effect of the opinion is evident from a critical analysis of it. The opinion (Appendix A) first states appellant's contention that the formula cannot be used in the face of the established relative non-productivity of its California business (238 P. 2d at 573), then states the facts relied on (ibid.), and then proceeds to state its answer to the contention. This answer at this point (238 P. 2d at 573-574; Appendix A, p. 28) is that in an unitary business

> "the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of the formula method in assigning to the taxing state its fair share of taxable values. (Butler Brothers v. McColgan, supra, 17 Cal. 2d 664, 667-668; Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, 477-479; El Dorado Oil Works v. McColgan, supra, 34 Cal. 2d 731, 735.)"

Our first comment about this statement is that it might have been taken directly from the opinion of the Supreme Court of North Carolina in *Hans Rees' Sons* v. *North Carolina*, which said:

> "The fallacy of this conclusion lies in the fact that petitioner undertakes to split into independent sources income which the record discloses was created and produced by a single business enterprise. • • •
>
> "• • • Certainly this could not be shown, as the petitioner has attempted to do in this case, by splitting up a single business into component parts and dividing the indivisible in order to reduce the tax." 199 N. C. 42, 153 S. E. 850, 854.

Since the United States Supreme Court disagreed with and reversed that view in the *Hans Rees* case, and since appellant's brief quoted the above language from the North Carolina court and pointed out to the California court the identity of the view which lost in the *Hans Rees* case and of that which it was being asked to adopt here, we do not believe the California court meant what it said in the foregoing quotation from its opinion to be the sole ground of decision.

Our second comment about the foregoing quotation from the opinion below is that it cites only authority from the California courts. It does not even cite the decision by the United States Supreme Court in the *Butler Brothers* case (315 U. S. 501), although it cites its own in that case. Perhaps this indicates a recognition that no decision from the Supreme Court supports that statement of the law.

Our third comment about that statement relates to the meaning with which the California court uses the term "separate accounting." As the California court uses the term, everything except formula allocation is "separate accounting." All evidence is rejected as constituting mere "separate accounting." As the *Hans Rees* case demonstrates, the Supreme Court has never taken this view.

The next step in the opinion below is taken after several more pages devoted to establishing a premise. That next step is summarized in this statement from the opinion (p. 32, Appendix A; 238 P. 2d at 576):

> "With regard to a unitary business, the place where expenses affecting the entire business are incurred has little or no bearing on the question of how such expenses should be allocated."

This fifth dimensional remark is not distorted by extraction from its context. Study of the context shows that the California court meant it quite literally.

If expenses are not to be allocated to the place where they are incurred, then net income, i.e., what is left after the expenses are deducted from gross income, has no identifiable geographical source! Moreover, if expenses are not identifiable with any particular geographical source, probably neither gross income nor gross receipts are, either. Then they all exist in limbo, a sort of fifth dimension.

Thus this statement, if taken literally, means that the allocaton formula can never be successfully attacked because net income has no real geographical source and therefore any formula which takes less than all the income cannot be shown to be unfair.

The opinion then discusses the unitary advantages of an unitary business and indicates a presumption, evidently conclusive since the evidence herein did not rebut it, that those advantages to the local portion of the business offset the local unfavorable disparities (Appendix A, p. 32; 238 P. 2d at 576).

Thereafter the California court returns, in a lengthy paragraph (Appendix A, pp. 33-34; 238 P. 2d at 576-577), to the proposition that in an unitary business the net income from any one state cannot be determined by any method but a formula, and thereafter concludes with two paragraphs which appear to say that the three-factor formula is so eminently fair and reasonable that it cannot fail to produce a reasonable result in any case of an unitary business.

It is therefore a fair analysis of the opinion to say that it asserts that it is impossible to allocate net income of an unitary business more accurately than the three-factor formula does it and therefore no successful attack on such a formula can be made. The support offered for this view is not in the peculiar structure of the formula but in the indivisible character of an unitary business. This position is no different than that adopted by the state court in

the *Hans Rees* case and repudiated by the Supreme Court, and is equally inconsistent with *Wallace* v. *Hines, supra*, and with what was said in *Norfolk & Western Ry. Co.* v. *North Carolina, supra.*

The nature of the three-factor formula has commended it to over half of the states using net income as a subject or measure of a tax. It is ridiculous, however, to assert that in it perfection has been attained. It contains tendencies to distort, as the facts here will demonstrate. Wages and salaries are one of the factors used. They are expenses in earning net income and as they increase in proportion to gross sales they reduce net income pro tanto. Yet, unless the increase in wages and salaries is uniform in proportion to gross sales throughout the states in which the taxpayer operates, the presence of larger wages and salaries will allocate more of the overall net income to the states where the presence of those larger wages and salaries actually deflated the net income below the average. That is exactly the effect the formula had here and is one reason for the wide difference between the taxpayer's and the State's figures.

The immunity of the three-factor formula to all attack has never been established by the Supreme Court. *Butler Brothers* v. *McColgan, supra,* 315 U. S. 501, sustained the same three-factor formula against the attack made on it in that case, and its reasonableness as a general proposition was accepted. Incidentally, the parties in that case stipulated that the three-factor formula was reasonable and proper if any formula could be used in the case (315 U. S. at 505), so that case is not an actual precedent on the point. However, the taxpayer merely offered its local books and the figures in them to establish the unfairness of the result. No peculiar conditions to distinguish the California business from the average were shown by the record, and, as the Supreme Court observed (315 U. S. at 508-509), for all the

record showed the same method by which the taxpayer had allocated a loss to California would have allocated a loss to each other state as well. One might say that this would have left the taxpayer's overall net income suspended in the fifth dimension in which the California court now places appellant's expenses—allocable to no particular state at all.

The opinion of the Supreme Court in the *Butler Brothers* case, and for that matter that of the California court in the same case, did not deny, but on the contrary affirmatively implied that facts of the sort found to exist here would overthrow the formula.

The question herein is therefore a substantial federal question under the decisions of the Supreme Court, and since it involves the constitutional immunity from attack of a formula in use in twenty states is of the utmost national importance.

Respectfully submitted,

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Dated: February 28, 1952.

APPENDIX "A"

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA, IN BANK

Sac. 6153

JOHN DEERE PLOW COMPANY OF MOLINE (AN ILLINOIS CORPORATION), *Plaintiff and Appellant,*

v.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA, *Defendant and Respondent*

Filed Dec. 19, 1951. William I. Sullivan, Clerk, By ——

Plaintiff brought this action to recover an additional franchise tax assessed against it for the taxable year 1938, based upon income for the year 1937, under authority of the Bank and Corporation Franchise Tax Act (Stats. 1929, p. 19, as amended; 2 Deering's Gen. Laws 1937, Act 8488, p. 3851) and paid under protest. The trial court found in defendant's favor, and from the judgment accordingly entered, plaintiff appeals.

The sole point in controversy is the propriety of the Franchise Tax Commissioner's application of a three-factor formula in measure of plaintiff's net income from business done within this state for the year involved. Plaintiff maintains that such formula attributes to California income derived wholly from business done without this state, so that such allocation is not only contrary to the governing act but likewise is objectionable as violative of the due process and equal protection of the law clauses of the Fourteenth Amendment. But an examination of the record in the light of settled legal principles sustains the use of the challenged formula as a reasonable method of apportionment for determining plaintiff's franchise tax liability in this state, and accordingly the judgment must be affirmed.

At all times herein mentioned plaintiff was an Illinois corporation, authorized to do business within this state, which business consisted of the sale of a full line of agricul-

tural machinery, implements, and tractors at wholesale to dealers. It maintained a jobbing house in San Francisco to serve the states of California, Arizona and part of Nevada, and in addition, it did a certain amount of exporting to the Orient. It also owned and operated four other jobbing houses, each serving trade in the surrounding territory and respectively located at Moline, Illinois; Omaha, Nebraska; Portland, Oregon; and Salt Lake City, Utah.

All of plaintiff's capital stock was owned by Deere & Company, an Illinois corporation, which was engaged in the business of manufacturing and selling farm equipment, with operations extending from the purchase of raw materials to the distribution of the finished products. Deere & Company also owned the capital stock of some 83 other corporations—manufacturing plants, factories, jobbing houses, and retail outlets—integrated into the general flow of business of Deere & Company in its production, handling and marketing of a full line of farm equipment. The various acquired companies functioned in the overall operations of Deere & Company in the following manner: different items were produced in the several manufacturing plants and factories, with the production process regulated so there would be no overlapping; the manufactured products were then transferred to Deere & Company, which in turn consigned them to the subsidiary jobbing corporations, and the latter thereupon disposed of the goods either through their own retail outlets or through independent retail dealers. In furtherance of the overall business, Deere & Company maintained at its offices a central purchasing department for quantity buying of the raw materials needed for the affiliated factories and manufacturing plants; a central financial department for negotiating bank loans, with Deere & Company advancing funds to the subsidiary companies as required; a central research laboratory for testing and improving the products of the factories; a central sales department for directing sales activities, fixing maximum terms and minimum prices to be observed by the jobbing houses, prescribing dealers' uniform contracts for said houses, and setting forth general policies on all sales matters; a central traffic department for arranging freight routing in response to orders from the jobbing houses as part of the marketing

function; a central advertising department for publication of a trade magazine and circulars, as well as for placement of national advertising; and a central insurance department for supervision of all insurance coverage for the properties and personnel of the affiliated companies. These and other central administrative departments in the Deere & Company organization established general management policies and operating procedures. Among important matters of policy determined by Deere & Company were volume discounts to be allowed by each jobbing house to retail dealers, warranties, retail store operations, accounting procedure, and pension plans affecting all the employees in the organization. Many of these matters were covered in branch house bulletins regularly sent by Deere & Company to its affiliated companies; the latter in turn rendered monthly accounts to Deere & Company as to financial status and operating expenses; and the jobbing houses, in reporting sale transactions, remitted to Deere & Company excess funds to be applied against their respective net accounts. Considerable freedom of action was allowed the local managers of the various jobbing houses so long as they kept within the broad outline of policy established by the central management. By such unity in ownership and control of the affiliated companies, Deere & Company effected substantial savings in the organization's integrated activities.

In 1934 Deere & Company entered into a distribution arrangement with the Caterpillar Tractor Company to meet a competitive trade development. That year the International Harvester Company and Allis-Chalmers Manufacturing Company, both of which produced lines of farm machinery competitive with the Deere line, commenced to manufacture track-type tractors and so provided their distributors with a decided advantage in being able to offer customers a complete line of agricultural equipment—tractors plus the implements to be used with them. While Deere & Company manufactured wheel-type tractors along with its line of farm machinery, it did not manufacture track-type tractors. On the other hand, Caterpillar did manufacture track-type tractors but not the farm equipment to be used with them. In recognition of their mutual business interest, the Deere organization and Caterpillar

arranged to have their respective products handled together by the same dealers, thus offering a full line of tractor and complementary farm equipment on a competitive basis with International Harvester and Allis-Chalmers. This connection with Caterpillar also enabled the Deere organization to develop its industrial as well as agricultural business so that it was not so completely dependent upon the farmer trade. Thus Caterpillar distributors throughout the country could handle the sale of Deere wheel-type tractors to industrial users so as to promote the use of such tractors with Caterpillar road machinery and other industrial equipment. The arrangement with Caterpillar was effected as a matter of policy by Deere & Company for general application to the entire organization.

The competitive situation was particularly acute on the West Coast in that differences in typographical, climatic and soil conditions as compared with other parts of the country caused track-type tractors to be much more widely used in that area than the wheel-type machines. This situation caused plaintiff to make some basic changes in its method of doing business pursuant to the arrangement between Deere & Company and Caterpillar to use common dealers, who would sell the combined products of both organizations to all classes of customers. In plaintiff's San Francisco trade territory the Caterpillar dealers were more strongly established, and accordingly plaintiff's San Francisco house discontinued doing business with practically all of its former dealers, numbering approximately 250, and began marketing its goods through Caterpillar distributors. Upon this basis plaintiff reduced its selling outlets to 44—retaining 25 of its old dealers as established in isolated communities and replacing its other dealer customers with 19 new Deere-Caterpillar distributors.

The use of former Caterpillar dealers for the distribution of the Deere line of products in the trade territory of plaintiff's San Francisco jobbing house necessitated plaintiff's undertaking an extensive program of education with regard to the selling and servicing of such goods; and additional salesmen were employed to visit the new dealers and acquaint them with the Deere output. Plaintiff's repair and

service departments in the San Francisco territory were revised and expanded, staffed with additional trained employees, and equipped with facilities to provide equivalent maintenance and care for both lines of goods. Upon the termination of its acounts with many of its former dealer customers, plaintiff's San Francisco house had to arrange for the goods in their hands either to be transferred to the new Deere-Caterpillar distributor who took over that part of the San Francisco trade territory or returned to plaintiff's San Francisco jobbing house. In some instances, after initial transfer to the new dealer, the old goods would subsequently be returned to plaintiff's San Francisco jobbing house for credit. The handling of all this merchandise by plaintiff's San Francisco jobbing house involved considerable checking and reconditioning of the goods, as well as the renting of additional storage space, with a resulting increase in warehouse and transfer expenses for plaintiff's San Francisco house.

The bulk of the goods sold by plaintiff's San Francisco house was purchased from Deere & Company for a price determined by applying agreed discounts to the minimum resale price of the goods to the retail dealers. Deere & Company charged the same uniform price to all jobbing houses in the organization for the various lines of goods, adjusting, of course, for freight differentials. The prices and terms so fixed for plaintiff's San Francisco house allowed it a gross profit margin from its sales comparable to that realized by the other jobbing houses operating in the Deere organization. However, in plaintiff's San Francisco trade territory the change in the dealer outlets markedly affected not only the expenses but also the income of the San Francisco house. Thus the new dealers, stronger and better financed as established Caterpillar distributors than the former Deere dealers with plaintiff's San Francisco house, were able to take greater advantage of the cash and volume discount rates allowed to plaintiff's dealers; and also the financial resources of the new dealers did not make it necessary for them to ask plaintiff for the rediscount of farmers' paper as received on the sale of goods. Upon such basis plaintiff claims that net income of its San Francisco jobbing house was materially reduced.

For the taxable year 1938 plaintiff filed an amended franchise tax return showing a California net income of $70,446.79, according to its separate accounting system, and the tax computed thereon was paid. Thereafter plaintiff received notice of an additional tax assessment of $12,-167.53, based upon the commissioner's determination of plaintiff's California net income in the total amount of $378,047.71, computed through use of a three-factor formula —property, payroll and sales—in allocating to plaintiff's California business a percentage of net income out of the consolidated net income of all the affiliated companies in the Deere organization. After protest had been made and overruled by the Franchise Tax Commissioner, plaintiff paid the additional assessment plus interest, and then filed this action for recovery of such payment.

Section 10 of the Bank and Corporation Franchise Tax Act, as in effect during the period here involved, provided that "if the entire business . . . is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State . . . determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of calculation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation." (2 Deering's Gen. Laws 1937, Act 8488, pp. 3851, 3858; Stats. 1929, p. 19; amended by Stats. 1931, p. 2226; Stats. 1935, p. 965.)

Plaintiff does not question the Franchise Tax Commissioner's determination that its California business was part of the unitary enterprise of Deere & Company as a multistate manufacturing and selling organization, and it concedes that formula allocation ordinarily produces a reasonable measure of taxing values for franchise tax purposes where a unitary business is involved. The commissioner here used the three factor formula of property, payroll and sales in computing the net income of plaintiff's San Francisco house, considered as an integral unit in the entire business comprising Deere & Company and all its affiliated

companies. (Edison California Stores v. McColgan, 30 Cal. 2d 472, 475.) Such formula has been recognized as embracing factors sufficiently diversified to reflect "the relative contribution of the activities in the various states to the production of the total unitary income" so as to allocate to California its just proportion of the profits earned from a unitary business. (Butler Brothers v. McColgan, 17 Cal. 2d 664, 678; aff. 315 U. S. 501, 509.) Its fairness in the apportionment of unitary income to sources within and without the state has been declared settled (Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, 479), consistent with "practical administrative difficulties that necessarily arise in fixing upon a workable formula for general application." (El Dorado Oil Works v. McColgan, 34 Cal. 2d 731, 738.) However, plaintiff maintains that here, as shown by its separate accounting system, the formula used has produced unreasonable results by assigning to this state extra-territorial values in the apportionment of the unitary income, and it therefore may not serve as an appropriate measure of its California franchise tax. But an analysis of the record fails to sustain plaintiff's position.

Plaintiff claims that the impropriety of the formula in question stems from its disregard of differences in both the expenses of operation and the productivity of income from the three factors of property, payroll, and sales in relation to its California business for the tax period involved. As shown by the accounting records, prepared at the home office of Deere & Company and covering the 9 affiliated jobbing houses in the organization but treating them as separate entities, plaintiff submits that its San Francisco house was not conducted so profitably as other jobbing houses in the national system. In this connection it refers to these conditions of variation from the national average as found by the trial court: that in 1937 "the San Francisco ratio was $6.76 in wages and salaries for each $100 of sales, whereas the average ratio for all included United States houses was $4.46," a difference of almost 50 per cent; that "in net tangible assets . . . the San Francisco ratio was $18.26 invested for each $100 of sales, whereas the average ratio for all included United States houses was $6.76," a difference of nearly 200 per cent; that

"in selling and general expenses . . . the San Francisco ratio was $13.676 of such expenses for each $100 of sales, whereas the average ratio for all included United States houses was $8.781," a difference of about 64 per cent; and that "the cash and volume discounts allowed to customers of the San Francisco jobbing house . . . were substantially higher in relation to sales than were such discounts allowed, on the average, by the other United States jobbing houses" in the organization. The trial court found that these accounting records were "accurately kept according to generally accepted accounting practices and • • • truly reflected" the ratio of the respective factors to the "gross receipts from sales." In this state of the record showing "proof of variations from the norm," plaintiff maintains that the formula operates to distort the productivity of its California business and cannot work properly in reasonably reflecting the proportionate part of the unitary income attributable to this state.

But in so arguing plaintiff fails to take into account the underlying concept of formula apportionment in the allocation of income from a unitary business: that the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of the formula method in assigning to the taxing state its fair share of taxable values. (Butler Brothers v. McColgan, supra, 17 Cal. 2d 664, 667-668; Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, 477-479; El Dorado Oil Works v. McColgan, supra, 34 Cal. 2d 731, 735.) As above stated, here the overall organization of Deere & Company was a manufacturing and selling business having its operations extending into a number of different states and providing an example of a typical unitary business subject to formula allocation as a reasonable method of apportionment for franchise tax purposes. (Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113; Bass, Ratcliff & Gretton, Ltd. v. State Tax Com.,

266 U. S. 271; North American Cement Corp. v. Graves, 299 U. S. 517; International Harvester Co. v. Evatt, 329 U. S. 416.) The fact that the taxpayer may show that according to a separate accounting system, the activities in the taxing state were less profitable than those without the state, or even resulted in a loss, does not preclude use of a formula as a method of apportionment of the unitary income. (Ibid.) The only requirement is that the formula used be not intrinsically arbitrary or produce an unreasonable result. Such was the situation in the case of Hans Rees' Sons v. State of North Carolina, 283 U. S. 123, where the court recognized the unitary character of the business as a manufacturing and selling enterprise extending into several states and to which a formula method of apportionment was appropriate, but refused to approve the particular formula employed for the reason that it consisted simply of the property factor and failed to give proper weight to the extensive activities of the company without the state, so that the result reached was unreasonable. (See Butler Brothers v. McColgan, supra, 17 Cal. 2d 664; 673; Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48, 60.)

In the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income (Butler Brothers v. McColgan, supra, 315 U. S. 501, 509; see Pacific Fruit Express Co. v. McColgan, 67 Cal. App. 2d 93, 100) and must not include income unconnected with the unitary business (People ex rel. Alpha Portland Cement Co. v. Knapp (N. Y.), 129 N. E. 202, 204-205, cert. den. 256 U. S. 702; also Fargo v. Hart, 193 U. S. 490, 501-502; Union Tank Line Co. v. Wright, 249 U. S. 275, 282-293; Southern Pacific Co. v. McColgan, supra, 68 Cal. App. 2d 48, 82; see Altman and Keesling, Allocation of Income in State Taxation, 2nd Ed., 1950, p. 97), but its propriety in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in further-

ance of the entire business sustains the apportionment process. (North American Cement Corp. v. Graves, supra, 299 U. S. 517; Ford Motor Co. v. Beauchamp, 308 U. S. 331, 336.) Thus in the case of Crane Co. v. Carson (Tenn.), 234 S. W. 2d 644, cert. den. 340 U. S. 906, the taxpayer was engaged in a unitary business consisting of a manufacturing and selling enterprise extending into several states. In challenge of the use of the statutory formula for apportionment of the overall business done within the taxing state, the taxpayer intrdouced voluminous records, according to its separate accounting system, to show that its factory in the taxing state suffered enormous losses by reason of unusual expenses for the tax period involved: increased payrolls upon the hiring of additional personnel, extended capital expenditures for enlargement and improvement of the manufacturing plant, and cost of reconversion from wartime to peace-time needs. The business as a whole was profitable. In upholding the statutory allocation formula as fairly calculated to assign to the taxing state that portion of the net income of the unitary business reasonably attributable to business done within its borders and involving no assessment of extra-territorial values, the court expressly noted that the taxpayer sought to treat the factory in question as "a separate entity" and "as though it did not maintain any retail sales organization," so that no consideration was given to their respective integrated contributions to the successful operation of the overall enterprise (P. 645).

A like situation prevails here in that plaintiff argues that unusual conditions affecting the conduct of its San Francisco jobbing house preclude reasonable application of the three-factor formula. Thus it refers to the effect of the above-mentioned Caterpillar transaction on its California business as involving an increase of operating expenses—through expanded payrolls, added repair and service facilities, extended warehouse handling and transfer charges—and a decrease in productive financial return—through the greater demand for cash and volume discount allowances on sales to the new strongly financed dealers. While plaintiff admits that the sales of its San Francisco jobbing house were slightly more productive of gross income

than were the sales of the other United States jobbing houses in the overall system (24.673 per cent as against 23.668 per cent, or an amount of $29,765.44 in favor of the San Francisco house above the average), it maintains that this advantage was more than offset by the substantially higher operating expenses of that house. But these expenses are not chargeable only to the San Francisco jobbing house and without regard for their effect on the business of the organization as a whole. As the record shows, the Caterpillar transaction was not an arrangement confined to plaintiff's San Francisco house as a local expedient, but was of general application to the entire organization as a matter of national policy and adopted as such by the directors of Deere & Company. By such arrangement both Deere & Company and Caterpillar were able to meet a serious competitive condition, which though more acute on the West Coast, nevertheless prevailed to a limited extent in other trade territories served by the jobbing houses in the Deere organization. Moreover, the arrangement gave Deere & Company an opportunity to develop on a national scale an industrial as well as an agricultural business, entailing not only an overall increase in business through entry of its farm equipment into the new field but also less dependence upon the farmer trade. As such matter of national policy, the Caterpillar transaction is not properly segregable to the San Francisco jobbing house in sale reduction of the income from its sales in view of the fact that it contributed to the advantageous operation of the entire business.

Likewise the property investments and payroll expenses of plaintiff's San Francisco jobbing house are not segregable solely to California business and in disregard of the unitary business of which it is an integrated part. In the balance of the three factors of the formula—property, payroll, and sales—the operation of the portion of the unitary business within one state is dependent upon or contributes to the operation of the unitary business without the state, and the California business of plaintiff's San Francisco jobbing house may not fairly be considered as a unit separate not only from other jobbing houses in the entire system but also from the manufacturing activities in the

national enterprise. (Underwood Typewriter Co. v. Chamberlain, supra, 254 U. S. 113, 120-121; Bass, Ratcliff & Gretton, Ltd. v. State Tax Com., 266 U. S. 271, 282.) With regard to a unitary business, the place where expenses affecting the entire business are incurred has little or no bearing on the question of how such expenses should be allocated. Thus, in the situation here involving the manufacture and sale of goods as a composite enterprise, selling expenses in one state may logically affect the amount of income realized from sales in other states through the following chain of processes: more sales in the aggregate, calling in turn for an increase in production, resulting in a reduced per unit cost, in consequence of spreading certain fixed or more or less constant charges over a broader base and increasing purchasing power so as to lessen the cost per unit of raw material, with the decrease in unit costs of goods manufactured causing an increase in the profit or income gained from sales in other states. Equally appropriate here is the statement made in Crane Co. v. Carson, supra, 234 S. W. 2d 644, at page 646, in relation to the propriety of formula allocation of unitary income from a manufacturing-selling enterprise: ". . . the final stage in the complainant's operation is the retail sale. However, the sale is merely the act by which the income is captured which has been the result of the complainant's entire operation, commencing with the purchase of raw material, its manufacture, and the transportation and distribution of the manufactured product to the final sale by the retail outlet." The same observation may be made with respect to plaintiff's property investments in California redounding to the benefit of the entire organization.

Nor does the fact that the trial court found that the accounting records of plaintiff's San Francisco jobbing house accurately set forth its California sales and operating expenses preclude the further finding that such "records . . . during the period involved did not accurately reflect the income of the plaintiff attributable to its operations and property within the State of California for said period." There is "no necessary inconsistency between the accuracy and fairness of the taxpayer's accounting and the different re-

sult obtained by the formula method of allocating income" (Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, 483), since a "particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders" (Butler Brothers v. McColgan, supra, 315 U. S. 501, 507), so that for "taxation purposes the one does not impeach the other." (Edison California Stores v. McColgan, supra, p. 483).

Plaintiff argues that contrary to the situation in Butler Brothers v. McColgan, supra, 17 Cal. 2d 664, 677, it has not "failed to show a variance from normal in either the California sales, property or payroll, or in either expenses or revenues," and that accordingly its showing responds to the test prescribed in Norfolk & Western Ry. Co. v. North Carolina, 297 U. S. 682, 688, in providing "clear and cogent" evidence "directed to each of (the related terms) alike in the formula so as to establish the unfairness of its application in the particular circumstances here involved. But regardless of the fact that the formula equation is not framed on the assumption that there must be uniformity of operating revenues and expenses in the relative functions of the various units contributing to the earnings of an integrated multistate business, an assumption which would be "contrary to notorious facts" (see Norfolk & Western Ry. Co. v. North Carolina, supra, p. 688), plaintiff's evidence is directed solely to prevailing ratio deviations affecting the selling activities of the Deere organization severed from the interrelated processes. Thus plaintiff shows merely that according to the three factors of the formula—property, payroll, and sales—its San Francisco jobbing house has not been so productive of income as other jobbing houses in the Deere organization; and so maintains that the formula, though fair on its face as representing a proper balance of accepted income producing factors (Silverstein, Problems of Apportionment in Taxation of Multistate Business, 4 Tax L. Rev. (1949), pp. 207, 258; Altman and Keesling, Allocation of Income in State Taxation, 2nd Ed., 1950, p. 37), works unfairly here. Such partial showing on the basis of plaintiff's separate accounting system misconceives the

whole purport of the unit rule of assessment as resting on the principle that "where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained." (Butler Brothers v. McColgan, supra, 17 Cal. 2d 664, 673; see, also, 315 U. S. 501, 507-508.)

Plaintiff does not suggest that another formula embracing different factors would produce a more accurate apportionment of the unitary business of the Deere organization done within and without the state (cf. Pacific Fruit Express Co. v. McColgan, supra, 67 Cal. App. 2d 93, 95; El Dorado Oil Works v. McColgan, supra, 34 Cal. 2d 731, 735-736), but it takes the position that notwithstanding the unitary character of the business, a separate accounting method furnishes an adequate measure of the activities of an integral part of that business—a proposition which has been consistently rejected by the courts. (Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, 480-481.) The fact that plaintiff, unlike the taxpayer in Butler Brothers v. McColgan, supra, 17 Cal. 2d 664, 665, in computing its California income according to its separate accounting system, has not taken any deduction for a pro rata amount of central office expenses or service charges, is of no significance insofar as determining the propriety of the use of a formula method of allocation. Although, as plaintiff maintains, such circumstance does indicate that it "has not sought the benefits of allocation of certain items while at the same time seeking to escape the burdens of allocation with respect to others," such claim of deduction was manifestly not the basis of the Butler Brothers decisions. (17 Cal. 2d 664; 315 U. S. 501.)

A state in attempting to place upon a business extending into several states "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders" (Underwood Typewriter Co. v. Chamberlain, supra, 254 U.S. 113, 121), and as a matter of practical tax administration it has been "declared that 'rough approximation rather than precision' is sufficient." (International

Harvester Co. v. Evatt, supra, 329 U.S. 416, 422.) As the record has been here analyzed, and particularly in the light of the decision in Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, plaintiff's San Francisco jobbing house operated as an integrated unit in the Deere organization, a manufacturing-selling enterprise, providing the advantages of a unitary business through "unity of ownership, unity of operation by centralized purchasing, management, advertising and accounting, and unity of use in the centralized executive force and general system of operation." (Pp. 479-480.) Consistent with these observations, the three-factor formula's application to plaintiff's San Francisco jobbing house appears to have "fairly calculated" the portion of the unitary income of the Deere organization "attributable to the business done within this state," and as so computed it is not open to constitutional objection as operating to tax extra-territorial values. (Edison California Stores v. McColgan, supra, 30 Cal. 2d 472, 483; Butler Brothers v. McColgan, supra, 315 U.S. 501, 507-509; International Harvester Co. v. Evatt, supra, 329 U.S. 416, 422-423). It therefore follows that the trial court properly sustained the additional franchise tax assessed against plaintiff for the year in question. (Underwood Typewriter Co. v. Chamberlain, supra, 254 U.S. 113; Bass, Ratcliff & Gretton, Ltd. v. State Tax Com., supra, 266 U.S. 271.)

The judgment is affirmed.

SPENCE, J.

We Concur: GIBSON, C.J.; SHENK, J.; CARTER, J.; TRAYNOR, J.; SCHAUER, J.

APPENDIX "B"

SECTION 10, BANK AND CORPORATION FRANCHISE TAX ACT OF CALIFORNIA.

If the entire business of the bank or corporation is done within this State, the tax shall be according to or measured by its entire net income; and if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof

which is derived from business done within this State. The portion of net income derived from business done within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacturer, pay roll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation.

If the commissioner reallocates net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1951

No. 682

JOHN DEERE PLOW COMPANY OF MOLINE
(AN ILLINOIS CORPORATION),

Appellant,

vs.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Appellee

APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA

STATEMENT OPPOSING JURISDICTION AND MOTION TO DISMISS OR AFFIRM

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MOTION TO DISMISS OR AFFIRM

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1951

No.

JOHN DEERE PLOW COMPANY OF MOLINE
(AN ILLINOIS CORPORATION),

Appellant,

vs.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Appellee

STATEMENT OPPOSING JURISDICTION AND MOTION TO DISMISS OR AFFIRM

MAY IT PLEASE THE COURT:

Appellee in the above entitled cause moves the Court to dismiss this appeal or to affirm the judgment below for the following reason:

There is no substantial Federal question presented as a basis of jurisdiction in this Court, because the questions presented have been foreclosed by previous decisions of this Court.

Wherefore, appellee moves the Court to dismiss the appeal in this cause for want of a substantial Federal question or, in the alternative, to affirm the judgment of the Supreme Court of California from which this appeal was

taken, for the reason that the questions presented are foreclosed by prior decisions of this Court.

Argument in Support of Motion

Statement of the Facts

The appellant is one of a number of affiliated corporations controlled by a common parent, comprising the Deere organization. The organization is engaged in the business of manufacturing and selling farm machinery and equipment. The opinion of the Supreme Court of California (38 Advance Calif. Reports, Second Series, 216, 238 Pac. 2d 569) contains a detailed statement of facts regarding the unitary nature of the business conducted by this organization and mentions certain of the advantages resulting from the unitary operation. We shall mention briefly a few of the principal features.

As it existed during the period in question, the organization was the outgrowth of a long series of transactions extending over many years, whereby the control of numerous corporations was acquired through stock purchases, mergers and consolidations. As a result of these processes, the businesses of the various corporations have been welded into one integrated business extending from the purchase of raw materials, through the manufacture of the machinery and equipment and the eventual retail sale thereof. Centralization of functions and management and control is exemplified in many ways, in the determination of policy, in purchasing of materials, in financing, control of factory operations and selling operations, accounting, operation of research laboratories, advertising, acquisition of insurance, maintenance of pension plans, preparation of bulletins and reports for the use of the different branches, operation of mixed car warehouses and in other ways.

The advantages flowing from the unitary operation are numerous and consist of such matters as savings of costs in the purchase of materials, savings in manufacturing costs, savings in freight charges and savings in sales expense, advertising expense and general operating expense. It is stipulated that by reason of the large scale purchases of raw materials and supplies by the general purchasing department of Deere & Company for the Deere organization, lower prices were obtained, freight savings were effected and better service from the suppliers was obtained (Def's Exh. A).

The trial Court found that the business conducted by the appellant was a portion of a unitary business conducted by the Deere organization. This finding is not disputed by appellant. Accordingly, the unitary nature of the business is not an issue in the case.

One particular transaction is referred to in some detail, since it is relied upon by appellant. This is the so-called Caterpillar transaction which commenced in 1934 when a tie-up was made between the Deere organization and the Caterpillar Tractor Company. The Deere organization entered into this transaction in order to meet the competition of International Harvester Company and Allis-Chalmers. The Deere organization did not manufacture a track-type tractor and did not wish to do so. On the other hand International Harvester and Allis-Chalmers did manufacture track-type tractors, with the result that their dealers were able to offer these tractors to the trade whereas the dealers handling the John Deere products were not. Caterpillar Tractor Company, on the other hand, manufactured track-type tractors, but did not manufacture the farm equipment needed for use in connection with them. By arranging to have their products handled by the same dealers, the Deere organization and the Caterpillar Tractor Company were able to offer a full line of tractor and com-

plementary farm equipment on a competitive basis with International Harvester and Allis-Chalmers. Moreover, one reason for the tie-up with Caterpillar which, of course, related to the manufacturing, as well as the selling activities of the Deere organization, was the desire of Deere to obtain the implement business that went with the sale of track type tractors (Def's Ex. E-5, page 89, which is also page 3 of Branch House Bulletin No. 774: ". . . we want the implement business that goes with these tractor sales . . .").

The Deere organization also entered into the tie-up with the Caterpillar Tractor Company because it afforded an opportunity to develop an industrial business as well as an agricultural business (Def's Ex. B-3 at page 5919: "Through this Caterpillar arrangement we will have an opportunity to get into this industrial business in an important way"). It was regarded as advantageous to have both industrial and agricultural business because it would mean increased business and because the business would not be so completely dependent upon the farmer trade (Def's Ex. E-5 at page 90, which is also page 4 of Branch House Bulletin No. 774). The Deere organization was enabled to develop industrial wheel type tractors for use in connection with suitable Caterpillar road machinery, as well as other industrial equipment (Def's Ex. E-5 at pages 40 to 44, which is Branch House Bulletin No. 791).

The Caterpillar connection was brought about as a matter of policy by Deere & Company and not by the San Francisco branch house. It was not a matter confined to the San Francisco branch house but was of general application to the entire organization (Opinion of Supreme Court of California, 238 Pac. 2d at page 571; second paragraph of Finding IV at page 35 of the printed record in the Supreme Court of California; Branch House Bulletins Nos. 773, 774, 781, 789 and 798, appearing at pages 24, 45, 71, 87, and 93 respectively of Def's Ex. E-5; Def's Ex. B-1 at p. 5895,

Def's Ex. B-3 at p. 5918, Def's Ex. B-3 at p. 5929, Def's Ex. B-4 at p. 5937).

Statement of the Case

The California Bank and Corporation Franchise Tax Act (Cal. Stats. 1929, Chapter 13, as amended) imposes on corporations doing business in California a franchise tax measured by net income attributable to business done within the state. (*Butler Brothers* v. *McColgan*, 315 U.S. 501, affirming 17 Cal. 2d 664, and *El Dorado Oil Works* v. *McColgan*, 340 U.S. 801, dismissing appeal from 34 Cal. 2d 731.)

The income of appellant subject to the measure of the tax was determined by first combining the income of the affiliated corporations comprising the Deere organization. This method was upheld by the California Supreme Court in *Edison California Stores, Inc.* v. *McColgan*, 30 Cal. 2d 472, 183 Pac. 2d 16. Appellant raises no objection to this procedure. On the appeal to the Supreme Court of California, as stated at page 10 of the typewritten Statement as to Jurisdiction, "*All objection to the consolidation of net income was abandoned* and the appeal was confined to statutory and constitutional objections to the use of the formula on this record." (Emphasis added.) Accordingly, this point is not at issue.

The portion of the total income attributable to business and activities within the state was determined by applying the same three factor formula of property, payroll and sales which was involved in the Butler Brothers case. The appellant contends that this is in error and that the apportionment should be made on the basis of its books of account by a method similar to the so-called separate accounting method employed by Butler Brothers in the case referred to above.

No Substantial Federal Question Is Presented

It is submitted that the questions presented have been decided adversely to the appellant by numerous previous decisions of this court. The principal cases to which reference will be made are:

Underwood Typewriter Company v. *Chamberlain*, 254 U. S. 113;

Bass, Ratcliff & Gretton, Ltd. v. *State Tax Commission*, 266 U. S. 271;

Hans Rees' Sons Inc. v. *North Carolina*, 283 U. S. 123, and

Butler Brothers v. *McColgan*, 315 U. S. 501.

The last case involved the identical statute in question here. In all the cases, the taxpayers were engaged in the conduct of a unitary business within and without the taxing state. In all the cases, apportionment of the income from the entire unitary business was made by means of a formula which was attacked on the grounds that the formula resulted in attributing to the taxing state income derived from operations in other states.

In both the *Underwood Typewriter* and *Bass, Ratcliff* cases, the formula method was sustained. From the opinions in the cases, it is clear that this Court considered that in the case of a unitary business, income must be considered as being derived from the functioning of the business as a whole and is not simply a mathematical product arrived at by a process of adding or subtracting the results of the various component parts of the business, such as manufacturing and selling. It is likewise clear from these cases that in apportioning the total unitary income among the states in which the business is conducted, any formula method may be employed which produces a reasonable result and which is not intrinsically arbitrary.

In the *Hans Rees* case, the results of the particular formula method there used were rejected but it is clear from the case that the objection was directed to the particular formula employed and not to the formula method as such. The formula consisted of the single factor of property which operated to attribute approximately 85% of the taxpayer's income to the taxing state. This result was found unreasonable on the ground that the formula failed to give any weight to the extensive selling activities of the taxpayer in other states. Significant in that regard is the language of the Court at page 133 of the opinion (283 U. S.):

> "Undoubtedly, the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and *all the factors* in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent and hence, when the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases." (Emphasis added.)

It might be observed in passing that the three factor formula of property, payroll and sales not only gives weight to outside selling activities, but also to other outside activities as well. Furthermore, its application in the instant case results in attributing less than 2% of the net income of the unitary business to California, as contrasted with the 85% of the net income of the unitary business attributed to the taxing state by the one-factor formula used in the *Hans Rees* case.

We come now to the *Butler Brothers* case which is most directly in point, inasmuch as it involved both the same statute and the same formula. It is true that in that case the taxpayer stipulated that the three factor formula was fair and reasonable and could be used, if any formula

method could be used. The taxpayer vigorously contended, however, that under the facts, the income attributable to California operations could not properly be determined by formula but instead should be determined on the basis of its books of account. Thus, the issue was squarely drawn as to the relative reasonableness of the formula and the separate accounting methods.

Although the appellant here does not formally make a concession similar to that in the *Butler Brothers* case as to the reasonableness of the formula, it concedes that generally, the particular formula is fair and produces a reasonable result. Furthermore, it does not dispute the fact that all of the elements of the formula are present in its business to a substantial extent, nor the fact that they contribute to the earning of income. It does not ask that any of the factors should be eliminated nor that other factors should be substituted or added. It likewise does not suggest that some different type of formula be employed. All that it urges is that under the circumstances, the income attributable to its California operations cannot reasonably be determined by means of the formula but should instead be determined according to its books of account, by the separate accounting method. Thus, the burden of its argument is the same as that of the taxpayer in the *Butler Brothers* case and consists of attempting to convince the Court that notwithstanding the fact that the portion of the business conducted within the state concededly is an integral part of a vast unitary business carried on within and without the state, the income attributable to such portion can more reasonably be determined by the separate accounting method than it can by use of a formula.

In view of the extensive consideration this proposition was given in the *Butler Brothers* case and the decision

therein, the matter will not be discussed here at length. It will be sufficient to observe that the separate accounting method may be appropriately employed in cases where the business conducted in a particular state is truly separate and distinct from the business or businesses carried on in other states. In such cases, both the gross income and the expenses attributable to the state where the separate business is conducted can quite easily and accurately be computed. The net income can be determined simply by subtracting the latter from the former. A very different situation is presented in the case of a unitary business where the total income from the entire business instead of being simply the arithmetical sum of the results of operations of separate businesses separately computed is instead a figure reflecting the operations of the entire business, no specific amount of which can be said to have emanated from any specific portion of the business. (*Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113, 121.) Any attempt to disregard the basic differences between the two situations and to employ the separate accounting method in apportioning the income of a unitary business must inevitably give rise to difficulties and uncertainties as fully recognized by this Court in the *Butler Brothers* case.

In support of its contention that a different result should be reached here than in the *Butler Brothers* case, appellant makes two contentions: (1) There were conditions peculiar to California not adequately reflected in the formula; and (2) The expenses of operation in California were substantially higher in terms of sales than the national average.

The "conditions peculiar to California" consisted apparently of the connection with Caterpillar described above and the resulting changes whereby the distribution of Deere and Caterpillar equipment would be made through common dealers. This included the use of some of the

former Caterpillar dealers in California since they were stronger and better established than some of the former Deere dealers. As indicated in the Statement of Facts, these changes may in no sense be regarded as an exclusively California matter and as having no connection with the unitary business. They were part of an over-all arrangement brought about by Deere & Company for the benefit of the entire Deere organization. The connection was established to meet a competitive condition which, if permitted to continue, would have adversely affected manufacturing activities conducted without the state, as well as selling activities conducted within California and certain other states. Moreover, the tie-up with Caterpillar also was established in order to obtain the implement business that went with the sale of track-type tractors and to develop industrial business so that the Deere organization would not be so completely dependent upon the agricultural trade. This, it is apparent, was significantly related to both the manufacturing and the selling activities of the Deere organization. (Cf. *Crane Co.* v. *Carson,* 191 Tenn. 353, 234 S. W. 2d 644, cert. den. 340 U. S. 906, in which the taxpayer there raised contentions similar to those of appellant.)

With respect to the second contention, the basic assumption underlying appellant's argument is that even in the case of a unitary business, the net income attributable to a particular state should properly be determined by subtracting the *expenses incurred* in that state from the gross receipts from sales made in that state. Thus, we are right back into the dispute between separate accounting on the one hand and formula on the other which, we believe, was settled in the *Butler Brothers* case. This assumption misses the whole point of the meaning of the word unitary.

This matter of how expenses should be charged was the

fundamental issue in the *Butler Brothers* case. In computing the gross income attributable to California under its separate accounting method, the taxpayer there, unlike the appellant here, subtracted only the actual cost of goods from the gross amount received from the sale thereof. Thus, the entire gross income from goods sold in California was attributed to that state. There was no mark-up to cover purchasing or manufacturing profits. Such a method was as fair to California as any determination of gross income under the separate accounting method could be. The taxpayer then proceeded to deduct from the gross income so arrived at the entire expenses incurred in California. This computation resulted in a substantial loss in California, notwithstanding that the business as a whole operated at a substantial profit. It seems apparent that, to borrow the phraseology of appellant, expenses incurred by Butler Brothers in California must have exceeded the national average in terms of sales. If this were not the case and the expenses incurred in California were proportionately no greater than in other states, then, since the California operations were unprofitable, it would follow inevitably that the business as a whole would likewise have been unprofitable. Thus, as we have said, realistically speaking, the fundamental issue in the *Butler Brothers* case was whether this method of charging expenses incurred in California was proper. The decision of this Court upholding the use of the formula method, we believe, fully and completely disposes of appellant's contention.

Appellant suggests at some length, that upholding the formula in the instant case would be equivalent to holding that it is invulnerable to constitutional attack. This does not follow. Although the three factor formula will probably eliminate the objection to the single factor formula employed in the *Hans Rees* case in most instances, there is no

certainty that it does so in all cases. There may well be instances where the activities of a particular business are of such a nature that they are not adequately reflected even by the three factor formula. On the other hand, there are numerous instances where all three factors of the formula are not present. One typical instance is that of personal service companies where property is not a material income producing factor. In such cases, to include property which may consist of nothing more than a small amount of office equipment located in one state would produce just as distorted results as were obtained in the *Hans Rees* case, There are still other instances which might be mentioned, but the foregoing will serve to indicate the fallacy of appellant's assertion.

We believe the cases we have discussed demonstrate that no substantial Federal question is here presented.

Additional decisions upholding the use of a formula in the case of a unitary business which we believe also support the view that no substantial Federal question is presented include *North American Cement Corp.* v. *Graves,* 243 App. Div. 834, 278 N.Y. Supp. 920, 269 N.Y. 507, 199 N.E. 510, affirmed 299 U.S. 517 (formula upheld as against elaborate accounting exhibits), *Commonwealth* v. *Ford Motor Co.,* 350 Pa. 236, 37 Atl. (2d) 329, appeal dismissed for want of substantial Federal question, 324 U.S. 827, (formula upheld despite separate accounting exhibits offered by taxpayer), *Parke Davis & Co.* v. *Cooke,* 198 Ga. 457, 31 S.E. (2d) 728, appeal dismissed for want of a substantial Federal question, 323 U.S. 681, *International Harvester Co.* v. *Evatt,* 329 U.S. 416.

Conclusion

Inasmuch as appellant's contentions concerning violation of the Fourteenth Amendment of the Constitution have been foreclosed by prior decisions of this Court we respect-

fully submit that this appeal should be dismissed or in the alternative that the judgment of the Supreme Court of California should be affirmed.

Dated: March 18, 1952.

EDMUND G. BROWN,
Attorney General of the State of California;
JAMES E. SABINE,
Deputy Attorney General;
IRVING H. PERLUSS,
Deputy Attorney General,
Counsel for Appellee.

IN THE SUPREME COURT OF THE UNITED STATES,
OCTOBER TERM, 1951

AFFIDAVIT OF SERVICE BY MAIL

No. —

JOHN DEERE PLOW COMPANY OF MOLINE (an Illinois Corporation), *Appellant,*

vs.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA, *Appellee*

STATE OF CALIFORNIA,
City and County of San Francisco, ss:

The undersigned, being duly sworn, says: I am a citizen of the the United States, over the age of eighteen years, a resident of the City and County of San Francisco, State of California, and not a party to the above entitled action; Kent and Brookes, the attorneys of record of the above-named appellant, maintain an office at 1720 Mills Tower in San Francisco, County of San Francisco, State of California; and between said two places there is a regular communication by mail; on the 18th day of March, 1952, I served a true copy of the Statement Opposing Jurisdiction and Motion to Dismiss or Affirm herein, to the original of which this affidavit is attached, on said last-named attorneys of

record, by depositing said copy on said date in the post office at the said City and County of San Francisco, enclosed in a sealed envelope addressed to said attorneys at the office thereof, and prepaying the postage thereon.

SHIRLEY GREENBLATT.

Subscribed and sworn to before me, this 18th day of March, 1952.

ERNEST P. GOODMAN,
Deputy Attorney General.

Table of Authorities Cited

	Pages
Butler Brothers v. McColgan, 315 U.S. 501	2, 3, 5
Hans Rees' Sons Inc. v. North Carolina, 283 U.S. 123	1, 2, 5
Kent-Coffee Mfg. Co. v. Maxwell, 291 U.S. 642	2
Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113	2

MOTION TO DISMISS OR AFFIRM

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1951

No.

JOHN DEERE PLOW COMPANY OF MOLINE (an Illinois corporation),
Appellant,

vs.

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,
Appellee.

REPLY TO MOTION TO DISMISS OR AFFIRM.

1. The State's motion to dismiss or affirm is based on four decisions of this Court, none of which supports the decision below.

Two of the decisions antedate *Hans Rees' Sons Inc. v. North Carolina,* 283 U.S. 123, and are sufficiently explained in that case so that there can be no doubt they do not stand for the broad proposition stated below in this case.

The *Hans Rees* case and the more recent decision in *Butler Brothers v. McColgan*, 315 U.S. 501, are the decisions about which this case centers. The State attempts to limit the *Hans Rees* case unfairly. For example, it says, "it is clear from the case that the objection was directed to the particular formula employed and not to the formula method as such."

Since the Court had already upheld the same kind of formula (*Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113), it could not have held the formula intrinsically invalid without destroying the authority of the *Underwood* case.[1] Instead it carefully distinguished that case, and we note that the State considers the *Underwood* case still authoritative since it is one of the four cases the State relies on in its motion.

The *Hans Rees* case challenged not the formula but its use on the facts of the particular case. Its opinion states, and, we submit, states quite clearly, that no formula, however reasonable in the abstract or in a majority of cases, can be upheld where it produces the type of result which it produced in the *Hans Rees* case.

The *Butler Brothers* case did not dispute the continued vitality of the *Hans Rees* case, but merely held that the type of evidence sufficient to bring the *Hans Rees* rule into application was absent in that case. In our Jurisdictional Statement we analyzed the case at some length and will not repeat that analysis here.

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[1]The Court subsequently upheld the identical North Carolina formula on another set of facts, in *Kent-Coffee Mfg. Co. v. Maxwell*, 291 U.S. 642.

If the Court understands the State's motion as representing that in this case we offered no evidence other than the type offered in the *Butler Brothers* case, then the Court will have been misinformed by the State. The record contains the following, none of which had even a remote counterpart in the *Butler Brothers* case:

1. Evidence showing that if the disparities found to exist by the trial court were removed, the State's formula would allocate the same net income to California as taxpayer's method does.

2. Evidence showing the amount of net income derived from all of the states.

3. The most detailed sort of evidence comparing costs of operation in California with costs in other states.

The last category of evidence led the trial court to make the following findings (Tr. 37-39):

> "The ratio of wages and salaries to gross receipts from sales, according to the books of the included corporations, which books were accurately kept according to generally accepted accounting practices and which truly reflected wages paid and gross receipts from sales made, was substantially higher for the San Francisco house than the average which prevailed for all included United States jobbing houses. For example, in the fiscal year ended October 31, 1937, the San Francisco ratio was $6.76 in wages and salaries for each $100.00 of sales, whereas the average ratio for all included United States houses was $4.46 in wages and salaries for each $100.00 of sales.

"The ratio of investment in net tangible assets to gross receipts from sales, according to the books of the included corporations, which books were accurately kept according to generally accepted accounting practices and which truly reflected investments and gross receipts from sales made, was substantially higher for the San Francisco house than the average which prevailed for all United States jobbing houses. For example, in the fiscal year ended October 31, 1937, the San Francisco ratio was $18.26 invested for each $100.00 of sales, whereas the average ratio for all included United States houses was $6.76 invested for each $100.00 of sales.

"The ratio of all selling and general expenses to gross receipts from sales, according to the books of the included corporations, which books were accurately kept according to generally accepted accounting practices and which truly reflected selling and general expenses incurred and gross receipts from sales made, was substantially higher for the San Francisco house than the average which prevailed for all United States jobbing houses. For example, in the fiscal year ended October 31, 1937, the San Francisco ratio was $13.676 of such expenses for each $100.00 of sales, whereas the average ratio for all included United States houses was $8.781 of such expenses for each $100.00 of sales."

These findings were not challenged by the State in the California Supreme Court, and they were accepted as correct by that court, but were considered irrelevant. The State cannot successfully challenge their correctness here. The issue is whether they are irrele-

vant, as held below, or are fatal to the State's position, as we contend.

The State attempts to dismiss these findings as based on "separate accounting." But in the loose and unjustified meaning the State gives that term, all evidence is "separate accounting," including that in the *Hans Rees* case. What "separate accounting" actually means, as used in the *Butler Brothers* case and the literature on the subject, is an allocation of net income based only on the books and records of the local branch. That is all that Butler Brothers offered to prove that the formula reached an improper result. The Court held more proof was needed, and suggested what some of the omissions were. This record supplies those omissions, and more.

The Court will search the State's motion in vain for a concession that there can be a case in which the three-factor formula fails properly to allocate the income of a manufacturing and selling business. The nearest approach to such a concession is the statement that in a personal service corporation a two-factor formula should be used instead of the three-factor formula! This points up our contention that the State is here arguing for the invulnerability of the formula method, regardless of the facts of the particular case, and it obtained a decree of such invulnerability below.

We submit that this Court has in the past steadfastly refused to sanction the states' attempts to put their formulae beyond attack. This new effort to at-

tain an old objective presents a substantial federal question.

2. The State has introduced a discussion of the taxpayer's Caterpillar arrangement based on the underlying record rather than on the facts recited in the opinion below. This discussion attempts to establish that the California disparity was an inevitable consequence of the Caterpillar arrangement, that it therefore had its counterparts elsewhere, and in any event the California disparity was the price appellant paid for the national advantages in the arrangement.

The State's argument is in two inconsistent parts. The first part—that the Caterpillar arrangement was national, not local, and therefore there cannot be local disparities—is in the teeth of the findings of disparities which we have quoted above.

The second part—that the local disparities can be ignored by California because they were the price paid for the national arrangement—we should suppose would present a very substantial federal question, indeed; if it were supported by the record. Both the recitation of facts in the opinion below and the underlying record establish that the local disparities grew out of decisions made for entirely local reasons. They were not the necessary consequences of any national arrangement but were the consequence of the fact the local branch house seized the opportunity to replace weak dealers with strong Caterpillar dealers. The decision had a temporarily disruptive effect on the business of the local branch house. When it was made, this effect was foreseen and was expected to

last for about five years. (Testimony of witness Kirk, Tr. 90-91; Tr. 76-91.) Both the motivation and the effect were local. The Court will therefore find the record fails to support the contention the State makes in its motion.

CONCLUSION.

This case involves an attempt by the State to establish a doctrine in conflict with existing decisions of this Court. It therefore presents a substantial federal question.

Dated, San Francisco, California,
April 2, 1952.

Respectfully submitted,
ARTHUR H. KENT,
VALENTINE BROOKES,
Attorneys for Appellant.